

## **MONTGOMERY COUNTY RETIREE HEALTH BENEFITS TRUST**

### **STATEMENT OF DERIVATIVES INVESTMENT PROGRAM**

The strategic objective of the use of derivatives is to facilitate risk management and to manage the cost of investing in publicly-traded stocks and bonds. A "derivative instrument" is defined in this document as an instrument which derives its value, usefulness and marketability from an underlying instrument which represents direct ownership of an asset or a direct obligation of an issuer, i.e. a "spot" or cash market instrument.

The use of derivatives allows the manager to separate risk and in particular, to target the specific risk defined within the manager's guidelines. In addition, derivatives may facilitate the implementation of more advanced investment strategies such as portable alpha and liability driven investing. These strategies may improve the portfolio's efficiency and assist with the aim of maximizing the expected return of the investments at a given level of risk.

The investment philosophy adopted by the Board of Investment Trustees which governs the use of derivative securities is as follows:

Derivatives should be used only in circumstances where they offer the most economic means of improving risk/reward profile of the portfolio (the cost of the derivative versus the cost of constructing an equivalent position in traditional securities).

Derivatives should not increase portfolio risk above the level that could be achieved in the portfolio using only traditional investment securities. In particular, the use of derivatives should not violate the Board's or investment manager's guidelines that limit exposure to market, sector, and security risks.

Derivatives should not be used to increase the dollar value of the position (economic leverage). Any leveraging of the portfolio is prohibited, unless expressly permitted by an investment policy and/or manager guidelines.

Derivatives should not be used to acquire outright exposure to changes in the value of assets or indices that by themselves would not be purchased for the portfolio.

These are the four basic strategies that can be achieved through the use of derivatives. Of these four strategies, substitution, risk control and arbitrage are permitted; speculation is prohibited.

#### **Permitted**

***Substitution:*** When the characteristics of the derivative sufficiently parallel those of the cash market instrument, the derivative may be substituted on a short-term basis for the cash market instrument, or on a longer-term basis to avoid withholding taxes. The strategy is particularly useful when investing cash flow or liquidating investments, since the derivative can be used to manage more precisely market entry and exit points.

***Risk Control:*** When characteristics of the derivative instrument sufficiently parallel those of the cash market instrument, an opposite position in the derivative can be taken from the cash market instrument to alter the exposure to or the risk (volatility) of the cash instrument. This strategy is useful to manage risk without having to sell the cash instrument. Sometimes referred to as "hedging," the use of the derivative in this context means that there is a high correlation in price movement between the cash market instrument and derivative instrument.

**Arbitrage:** When a transaction is done for profit based on a price difference between a derivative and a similar fungible cash instrument, this transaction is known as arbitrage. This involves the simultaneous purchase and sale of two instruments for the purpose of capturing a pricing disparity between them. An example of this transaction is an index arbitrage where a simultaneous trade to buy an index of stocks and a trade to sell a similar index futures contract occurs, where the sale of the index futures contract may be higher than the purchase. This transaction allows the arbitrageur to gain a profit from the price difference between similar securities. This usually takes place due to different markets, exchanges or instruments. This is only permissible when expressly stated by an investment policy and/or manager guidelines.

### **Not Permitted**

**Speculation:** When the derivative is purchased or sold for the purpose of achieving a higher possible gain than traditional investments but the investor recognizes that a higher probability of loss could be realized, this transaction is called speculation. An example of speculation is the purchase or sale of an option with the sole purpose of achieving gain. The investors assume the risk taken by purchasing or selling the option with the understanding that they could lose all of their invested principal due to the finite life of the option. The goal of every program should be the attainment of the best risk adjusted returns for the portfolio.

The derivative instrument market is evolving and new instruments are created constantly, therefore listing permissible and non-permissible securities is not possible. Rather than list each derivative security, classes of derivatives will be described below, and may only be used by managers with guideline authority in their investment manager agreements to do so. The prohibitions and examples are designed to enhance interpretation and understanding of this philosophy and should not be considered an exhaustive list. Any derivative transaction, or action not specifically permitted with this Derivatives Program (“Program”), is prohibited unless approved by the Board. Managers must request approval for any policy exceptions to this Program.

**Futures Contracts:** Investment managers who are permitted to invest in the underlying or deliverable cash market instrument may use stock index futures, interest rate/bond futures and currency futures contracts which are Commodities and Futures Trading Commission (CFTC) approved.. Financial futures may be used to manage the duration of the portfolio, to implement sector changes rapidly, and as a substitute for physical securities when advantageous. The use of futures provides substantial benefits in terms of reduced transaction costs and flexibility to invest in physical securities with different maturities. Financial futures should be used in a manner consistent with the overall duration target and investment objectives.

The face value of interest rate futures contracts shall be defined as the duration-adjusted bond equivalent value of the contract. The objective of this adjustment is to equate the price volatility of short-term credit market instruments with the price volatility of long-term credit market instruments. The adjusted face value will be used for all exposure calculations.

**Options:** Investment managers permitted to invest in the underlying or deliverable cash market instrument or whose mandate is to overlay a designated portfolio of deliverable cash market instruments may use stock index options, options on stocks and bonds and currency options, and exchange traded options on futures..

Futures and options contracts shall be limited to liquid instruments actively traded on major exchanges and Over-the-Counter.

**Currency Forward Contracts:** Investment managers permitted to invest in the underlying or deliverable cash market instrument or whose mandate is to overlay a designated portfolio of deliverable cash market instruments may use currency forward contracts.. Foreign exchange transactions may occur between foreign currencies (cross currencies) when made in anticipation of future sales or purchases of securities or when consistent with the investment manager's currency management guidelines.

Unless expressly permitted in the investment manager's guidelines, forward positions should not have a notional value, as measured in local currency, greater than the currency asset being hedged, allowing for short-term fluctuations due to operational aspects of trading and pricing. Further, managers are required to diversify roll dates when significant levels of hedging are in place, e.g. over 50% of the account value, or when roll dates extend beyond six months. Individual counter party [notional and/or gross gain/loss] exposure is limited to 5% of the Montgomery Employee Retirement System Fund. Derivative positions will be marked-to-market daily.

**Swaps:** Swaps which may provide for the receipt of the rate of return of the permitted cash market instrument are allowed. For currency forward contracts and swaps, counter party credit risk will be monitored by Staff. Counter party credit worthiness shall be equivalent to investment grade A (S&P) and/or A (Moody's), and exposure will be defined within individual manager guidelines. For non-exchange traded derivatives, individual counter party exposure is limited to 5% of the RHBT. Derivative positions will be marked-to-market daily.

**Structured Notes and Mortgage Derivatives:** Structured notes and mortgage derivatives are permitted and are expressly addressed in manager's investment guidelines. However, certain structured notes may not be used if they have the following characteristics:

- significant difficulty or imprecision in measuring risk of the security or its underlying collateral.
- highly unpredictable cash flows
- poor liquidity
- implied leverage
- subject to dramatic duration shifts with changes in interest rates (extension risk), such as floating rate securities whose interest rate reset provisions are based on a formula that magnifies interest rate changes, e.g., inverse floaters or leveraged floaters.

Individual counter party exposure is limited to 5% of the RHBT Derivative positions will be marked-to-market daily.

Floating rate reset mechanisms must be tied to domestic fixed income indices. Cost of funds indices and foreign exchange indices are examples of inappropriate floating rate structures.

Specific structures and constraints will be addressed in managers' guidelines.

**Warrants:** Purchasing warrants separately is prohibited; however, warrants are permitted when attached to securities authorized for investment.

**Credit Default Swaps:** The purchase and sale of single issuer and basket/index credit default swaps are permitted for use by managers, if expressly permitted in the manager's investment guidelines included in its contract. High yield credit default swaps may not be used to create a net short position for a single issuer.

## **Reporting Requirements**

Prior to initiating a derivatives position, the manager must provide a written Derivatives Program and procedures. Daily the manager must mark-to-market the derivative positions through the use of a daily pricing service and reconcile cash and margin positions to the custodian bank.

Managers must provide a report quarterly that outlines by derivative:

- counter-parties used, quality of the counter-party, and the market value, cost value, gain/loss, notional exposure, and amount of exposure;
- a description of the strategy and expected outcome of the derivative use; and the quantified impact to the portfolio.

## **Responsibilities and Delegations**

The Board is responsible for approving and amending the Program and has delegated responsibility for administering the Program to the Board staff.

The Board staff shall review the written policies and procedures of the external money managers with respect to derivative use and shall monitor reports from the manager and master custodial bank at least quarterly to ensure derivative use is in compliance with this Program.

The managers are granted investment discretion under their investment management agreements subject to any restrictions in their investment management guidelines. The Board delegates to the managers the execution of derivatives transactions under this Program. The managers permitted to use derivatives must comply with this Program. Nothing in this Program supersedes the managers' legal obligations to the Board contained in their investment management agreement.

ADOPTED: May 16, 2008